REACHING FAR & WIDE

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Emerging markets have long presented a problem for ESG investors, but recent developments mean they're no longer out of reach

The yawning gaps in a globally allocated environmental, social and governance (ESG) portfolio are finally starting to close as resources and processes are developed to deal with challenging asset classes and markets.

Gatekeepers and asset allocators no longer have to face the Hobson's choice of an incomplete portfolio or no portfolio at all.

But, with the enhancement of global asset coverage, analysts evaluating new ESG managers have to recalibrate and in some cases reframe their analysis in order to discern whether these newly available strategies are merely better than nothing or truly commensurate with the seasoned strategies occupying the rest of the asset map.

PLUGGING THE GAP

Of the major asset classes, emerging markets (EMs) have probably been the most needed and least well represented for US-based ESG investors. EMs pose the dual challenge of limited availability of evaluative ESG data and market environments predisposed to the types of security characteristics that fall out the bottom of a robust ESG investment process.

However, conditions have improved in many, but not all, of the areas investors need coverage.

For example, companies in EMs have stepped into the lead in sustainable and regenerative industries such as solar and wind power generation. North American and European companies that endeavor to operate more sustainably are driving change in their supply chains, which often extends to corporate partners in EMs.

Data providers available to US investors have responded, expanding and deepening their coverage of a growing and improving selection universe.

Good governance initiatives in many countries are making companies more investable as well, and exchanges have displayed a growing recognition that marketplaces of better governed, more transparent and more sustainable enterprises attract more market participants and more capital.

European investment firms with ESG facilities and plenty of experience operating in EMs have started bringing strategies and capabilities to the US. More domestic firms have also started fundamental, quantitative and index ESG strategies addressing EMs.

COUNTING THE HUMAN COST

What still needs to improve? Many emerging (and frontier) markets still suffer from outsized political and regulatory risks with ESG implications.

It is almost automatic for EM managers, whether for bonds or equities, to pay attention to the risk of a devalued currency, the erasure of or a default on debt, government hands in private enterprise, nepotism, graft and outright corruption. We can file all of that under 'governance'. But the 'environment' and 'society' parts of ESG are often not quite so critical for traditional investors.

Flushing pollutants into waterways, underpaying workers and providing them with unsafe and unhealthy working conditions could provide better shareholder returns – all while communities and workers have no legal recourse to protect their environmental and societal interests.

Doing business with blacklisted governments or operating in areas against the interests of local populations (South Sudan and Darfur as a stark example) may work in favor of a company's strategic interests in terms of access to natural resources, but comes at a profoundly negative price when measured in terms of human rights.

STRUCTURAL CHALLENGES

Companies and governments in developed markets are not free from these concerns and controversies, but the prevalence of these issues in EMs makes them a structural challenge to portfolio creation.

Transparency and disclosure around ESG factors is still difficult to come by in EMs, with much to be understood that will not appear in standard market or regulatory reporting.

It falls to investment bank and asset manager analyst teams and research providers such as MSCI, Sustainalytics, Vigeo Eiris and FTSE Russell to gather and contextualize the data and insights necessary to implement a robust ESG process across markets.

THE CASE FOR BLACKLISTING

A best-in-class approach on its own may not be sufficient given the potential pitfalls, and a degree of exclusion ought be intrinsic to avoid the potential or the reality of controversial activities.

In EMs more than many other areas of the capital markets, the trajectory of improvement and the work yet to be done provide fertile ground for pursuing the aligned interests of people, planet and profit.

The difference between the best performer and most egregious offender in a developed Western democratic economy is not nearly as dramatic as in EMs and frontier markets.

These metrics can be used to build sustainable portfolios in EMs that are objectively superior to the alternative, and where the expression of ESG contributes directly and discernibly to the long-term performance of investible securities and portfolios. ■